(1)

Supreme Court, U.S.
FILED

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No.

In the Supreme Court of the United States

YVETTE GAFF KLEVEN, Trustee
MARK A. WARSCO, Trustee
DAVID R. DUBOIS, Trustee,

Petitioners,

v.

HOUSEHOLD BANK F.S.B.,

Respondent.

On Petition for Writ of Certiorari To The United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

I. Whether the "ordinary course of business," as defined under 11 U.S.C. §547(c)(2)(B), of a consumer debtor presents a factual inquiry regarding an analysis of debtor's transactions with all of his or her creditors.

PARTIES TO THE PROCEEDING BELOW

The caption of the case contains the names of all the parties to the proceeding below.

CORPORATE DISCLOSURE STATEMENT

Supreme Court Rule 29.6 is inapplicable because Petitioners Yvette Gaff Kleven, Mark A. Warsco, and David R. Dubois, are all Trustees in this matter, not corporations.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit dated June 30, 2003 appears in the Appendix to this Petition for a Writ of Certiorari. (App. A at 1a). Its official citation is *Kleven v. Household Bank F.S.B.*, 334 F.3d 638 (7th Cir. 2003). The district court's Memorandum of Decision and Order of July 26, 2002 also appears in the Appendix to this Petition for a Writ of Certiorari (App. B and C at 11a and 13a). It has not been published. The bankruptcy court's opinion of January 15, 2002 appears in the Appendix to this Petition for a Writ of Certiorari. (App. D at 23a). Its official citation is *Warsco v. Household Bank F.S.B.*, 272 B.R. 246 (Bkrtcy N.D.Ind. 2002).

JURISDICTION

The United States Court of Appeals for the Seventh Circuit entered a judgment affirming the District and Bankruptcy Court's decision on June 30, 2003. Pursuant to 28 U.S.C. §1254(1), this Court has jurisdiction to review the judgment of the Seventh Circuit on a writ of certiorari.

RELEVANT STATUTORY PROVISIONS

11 U.S.C. §547(c)(2) provides that:

The trustee may not avoid under this section a transfer -

* * *

To the extent that such transfer was -
a) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

b) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
c) made according to ordinary business terms[.]

STATEMENT OF THE CASE

These consolidated lawsuits represent efforts by three Chapter 7 bankruptcy Trustees ("Trustees") to avoid and to recover for the benefit of the respective bankruptcy estates certain federal income tax refunds which Household Bank, F.S.B. ("Bank") applied to the respective pre-bankruptcy indebtedness of the various debtors (individually, a "Debtor"; collectively, "Debtors"). The federal income tax refunds at issue were applied to the Debtors' obligations to the Bank either within 90 days prior to bankruptcy, or in certain cases, after the bankruptcy petition of that Debtor had been filed. The Bank's action in taking funds from a special bank account in the name of the Debtor and applying that money to a pre-existing loan was challenged, alternatively, as being an avoidable setoff pursuant to 11 U.S.C. §553(b) and 11 U.S.C. §549, or a pre-petition preference pursuant to 11 U.S.C. §547.

All of the actions were consolidated for purposes of decision-making in the Bankruptcy Court. On July 13, 2001, the parties prepared and filed Stipulations of Fact and Law With Regard to Consolidated Adversary Proceedings ("Stipulations"). (App. E at 35a). The Stipulations provide, *inter alia*, that the transfers at issue were made in the ordinary course of the Bank's business or financial affairs and were made in accordance with the ordinary business terms of parties in the tax refund loan industry. The Stipulations do not address any Debtor's treatment of any creditor other than the Bank. The consolidated proceedings were then submitted for decision upon the Stipulations and briefs.

By judgment dated January 15, 2002, *See* 272 B.R. 246, the Bankruptcy Court ruled in favor of the Bank, and directed the dismissal of all of the adversary proceedings. With one exception (R. David Boyer), the Trustees appealed the Bankruptcy Court's decision to the District Court, where the proceedings were again consolidated. On July 26, 2002, the District Court entered its Judgment in a Civil Case and accompanying Order, in which it affirmed the decision of the Bankruptcy Court.

The Trustees timely appealed the District Court's Judgment to the United States Court of Appeals for the Seventh Circuit. On June 30, 2003, the Seventh Circuit affirmed the decision of the District Court.

BASIS FOR JURISDICTION IN THE BANKRUPTCY COURT

The bankruptcy court had jurisdiction in this matter pursuant to 28 U.S.C. §1334(b), 28 U.S.C. §157(B), 28 U.S.C. §157(B)(2), and Bankruptcy Rule 7001.

ARGUMENT

I. Introduction.

The Trustees sought to recover the payments at issue under the theory that the transfers constitute preferences avoidable under 11 U.S.C. §547. The Bankruptcy Court, the District Court, and the Court of Appeals each denied the Trustees' claims. Each court held that the transactions at issue were excepted from avoidance under §547(b) as transfers "in the ordinary course of business."

11 U.S.C. §547(c)(2) provides:

The trustee may not avoid under this section a transfer -

* * *

To the extent that such transfer was -
a) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
b) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
c) made according to ordinary business terms[.]

The purpose of the ordinary course of business exception is to leave undisturbed normal commercial and financial relationships and protect recurring, customary credit transactions which are incurred and paid in the ordinary course of business of both the debtor and the debtor's transferee, *See, Johnson v. Barnhill* (*In re Antewil*), 931 F.2d 689, 693 (10th Cir. 1991), *aff'd*, 503 U.S. 393 (1992), and to discourage unusual actions by either the creditor or the debtor. *Central Hardware Company v. Sherwin-Williams Company* (*In re Spirit Holding Co., Inc.*), 153 F.3d 902, 904 (8th Cir. 1998); *Riske v. C.T.S. Systems, Inc.* (*In re Keller Tool Corp.*), 151 B.R. 912, 914 (Bankr. E.D. Mo. 1993) (*quoting Union Bank v. Wolas* (*In re ZZZZ Best Co., Inc.*, 502 U.S. 151, 112 S.Ct. 527, 532 (1991)).

If the purpose of the ordinary business exception is to encourage creditors to continue dealing with troubled debtors and to discourage unusual action by either the creditor or a debtor, the threshold questions is, "Does the ordinary business exception even apply to the transactions at issue here?" Stated differently, is there any reason to encourage

the Bank to extend credit to a troubled (in each case, insolvent) debtor? What beneficial purpose is served by encouraging the Bank to extend incredibly expensive credit to insolvent debtors? Why would the Bankruptcy Code or the courts want to so encourage the refund anticipation loan industry to reap huge profits off insolvent debtors immediately prior to a bankruptcy filing, while the remainder of the debtor's creditors receive nothing? What social or commercial purpose is accomplished?

II. The circuit courts have interpreted the breadth of the ordinary course of business defense in fundamentally different ways.

A. The Seventh Circuit interpretation of 11 U.S.C. §547(c)(2)(B).

In its analysis of the "ordinary course" defense of §547(c)(2) in these consumer cases, the Seventh Circuit focused on whether the transaction was ordinary: (a) as between the parties, and (b) "in the industry examined as a whole." The parties stipulated that the transactions were ordinary within the tax refund loan industry. As a result, the Seventh Circuit focused only on whether the transactions were ordinary as between the Bank and the individual Debtors.

Some of the Debtors had engaged in similar transactions in prior years. For those Debtors, the Seventh Circuit found the transactions to be within the ordinary course. As for Debtors who had not engaged in such transactions, the Seventh Circuit concluded the transactions were in the ordinary course because the transactions were accomplished in accordance with the terms of the parties' agreement. That the transactions had been entered into previously and were accomplished in accordance with the terms of the parties'

agreements does not, however, address the issue of whether the transaction itself is within the "ordinary course" for a particular debtor, and in particular his or her treatment of other creditors.

The lower courts appear to apply different criteria to commercial transactions than to consumer transactions. For example, in *In re Milwaukee Cheese, Inc.*, 112 F.3d 845, 848 (7th Cir. 1997), involving a commercial case, the Seventh Circuit reviewed whether the nature of a transaction as a whole was ordinary for that particular debtor, without regard to whether the transaction was accomplished in accordance with the terms of the parties' agreements. In *Milwaukee Cheese*, the debtor repaid certain savings accounts to its employees. In response to the trustee's suit to avoid the payments as preferential, the employees claimed the ordinary course defense. In evaluating the defense, the Seventh Circuit noted that the debtor had financed its payments to the employees by borrowing from a bank and giving security in exchange. The Seventh Circuit held "that kind of transaction was extraordinary for the firm. Section 547(c)(2) offers no defense; if it did, then it would exempt from §547(b) the kinds of transactions that lie at the section's core." 112 F.3d at 848.

It is important to note that in *Milwaukee Cheese*, the Court did not evaluate the terms of the transaction itself; one would assume the borrowing was done in accordance with normal terms and within the terms of the agreements at issue. It was not the terms of the borrowing, but the **fact** of the borrowing, that made the transaction extraordinary.

There is no evidence in the record of these cases regarding whether the payment by the Debtors, or the transactions in general, were ordinary for the various Debtors. In particular,

there is nothing in the Stipulations regarding the Debtors' normal payment practices, or the nature of any other obligations owed by the Debtors, including whether the Debtors ordinarily entered into high interest, extremely short-term transactions with other creditors. Nevertheless, the statute specifically provides that the creditor bears the burden of proving its defense. 11 U.S.C. §547(g).

The question thus becomes, how does a creditor prove the "ordinary course" for a consumer debtor? In theory, the issue presents a factual inquiry. However, notwithstanding its recognition, in the commercial context, that the "ordinary course of business" defense of 11 U.S.C. §547(c)(2) requires an analysis of the nature of the transaction in light of the debtor's normal transactions, in the consumer context the Seventh Circuit simply assumes that the transaction is "ordinary" for each of the individual Debtors, even without the benefit of facts relating to the treatment the Debtors afford their other creditors. Because there is no evidence regarding the ordinary nature of the transactions from the Debtors' perspective, Trustees respectfully submit the Bank's defense must fail as a matter of law.

B. The Eighth Circuit interpretation of 11 U.S.C. §547(c)(2)(B).

In contrast to the Seventh Circuit's analysis in these cases, in *In re Armstrong*, 29 F.3d 517 (8th Cir. 2002), the Eighth Circuit, under circumstances very similar to the instant case, held that the "ordinary course of business" defense in a consumer transaction requires evidence that the transaction is "within the ordinary course of the debtor's financial affairs." *Id.* at 527. *Armstrong* involved a trustee's attempts to recover, as preferential transfers, payments of short-term "markers" owed to a casino. The *Armstrong* court noted, in

particular that "there was no evidence presented that the transfer was within the ordinary course of the debtor's financial affairs." *Id.* Without such evidence, the Eighth Circuit held that the creditor failed to prove an essential element of the "ordinary course of business" defense.

C. A clarification of the scope and breadth of the ordinary course of business defense is necessary.

Trustees respectfully submit that the "ordinary course of business" for consumer debtors is an issue upon which the Circuits are split and about which guidance from this Court is needed. The vast majority of bankruptcies in this county are consumer bankruptcies; one might assume that the vast majority of preference actions similarly arise in consumer bankruptcies. Clarity regarding the factors comprising a consumer debtor's "ordinary course of business" would inure to the benefit of all interested parties.

III. Conclusion.

Accordingly, Trustees respectfully request that the Court grant this Writ of Certiorari to address the factors comprising a consumer debtor's "ordinary course of business."

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 02-3127

[January 24, 2003, Argued
June 30, 2003, Decided]

YVETTE GAFF KLEVEN, Trustee,)
MARK A. WARSCO, Trustee,)
DAVID R. DUBOIS, Trustee,)
Plaintiffs-Appellants,)
)
v.)
)
HOUSEHOLD BANK F.S.B.,)
Defendant-Appellee.)
)

Appeal from the United States District Court
for the Northern District of Indiana, Fort Wayne Division
No. 1:02CV26
William C. Lee, Judge

JUDGES: Before RIPPLE, EVANS, and WILLIAMS, Circuit Judges.

OPINION

TERENCE T. EVANS, Circuit Judge.

Today, some people can buy a luxury automobile, say a Lexus or a Cadillac, and pay it off with an interest-free loan. The signs are everywhere: "Zero % financing." People in the market for luxury cars, however, are not in the market for Refund Anticipation Loans (RALs), the subject of the appeal in this case. RALs attract millions of people who are short on cash--those who either can't wait, or choose not to wait, for the Internal Revenue Service to process their income tax returns and send them a refund check through the mail. These people want their money now, and to get it they use a tax preparer like H & R Block and strike a bargain with a bank like Household, the defendant here. The bargain struck is a good one for only one of the two parties. Guess which one?

We start with a little background on RALs and some statistics from Milwaukee, a fairly typical American city. According to the national research, over half of all U.S. tax filers use commercial tax preparers, but the marketing of RALs is aimed mainly at low income families eligible for the earned income tax credit (EITC). Most of these people are without personal bank accounts in which to receive a direct deposit tax refund. A recent report, prepared by the University of Wisconsin-Milwaukee Employment and Training Institute in cooperation with The Brookings Institution, reviews the use of RALs by ZIP Code areas in central city Milwaukee neighborhoods. The report used the tax year 2000 and data obtained by Brookings staff from the Internal Revenue Service. Nine central city Milwaukee ZIP Codes in the heart of Milwaukee's Community Development Block Grant (CDBG) neighborhoods–the poorest

neighborhoods--were analyzed, as well as other more affluent areas of the city and its suburbs. The study disclosed that in Milwaukee County, 29,458 tax filers claiming the federal earned income tax credit used tax preparers and borrowed against their refunds through RALs prior to receiving them from the IRS. The lion's share of these filers lived in Milwaukee's distressed CDBG neighborhoods.

The Brookings study found that national tax preparation chains typically charge around $100 for preparing and filing a simple tax return and an additional $75 to $100 fee for a RAL. At these rates, the study concludes, lower-income Milwaukee filers who used commercial tax preparers and RALs lost $5.5 million in tax refunds and federal EITC payments in 2000.

In a fairly routine case, a tax return filer like those identified in the study pays a fee for preparation of the return--say $100. The return discloses a refund due most likely from the EITC of, say, $600. After paying the tax preparer's fee, the filer has a choice: wait for an IRS check for $600 or enter into a RAL for a fee, usually around $75. Because walking out with $525 (or $425 if the tax preparation charge is rolled into the deal) apparently seems like a better option than waiting for $600, the bargain is struck. And unlike the Lexus buyer paying zero percent annual interest, the filer pays what amounts to an exorbitant interest rate--often over 100 percent--when computed on an annual percentage basis. For more on the study we have referred to see Alan Berube, Anne Kim, Benjamin Forman and Megan Burns, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC* (The Brookings Institution and the Progressive Policy Institute, May 2002); Anne Kim and Alan

Berube, "Fast Cash for the Tax Man," *Blueprint Magazine*, May 21, 2002; and "Use of Refund Anticipation Loans by Earned Income Tax Credit Filers in Central City Milwaukee Neighborhoods," a study by Lois M. Quinn, Employment and Training Institute, School of Continuing Education, University of Wisconsin-Milwaukee, June 2002.

As we see it, an attack on RALs based on fairness and equity would certainly have some appeal. But the appeal we consider today attacks RALs from a different angle. In our case, over 100 adversary proceedings were consolidated in the bankruptcy court, and all of them present the same question: What happens when a tax filer enters bankruptcy proceedings within 90 days of signing off on a RAL? The plaintiffs are trustees in chapter 7 cases seeking to recover the tax refund payments received by Household Bank. The trustees want to get their hands on the funds under two theories, arguing that the funds are impermissible setoffs or avoidable preferences under §§ 553 and 547 of the Bankruptcy Code.

The transactions in question proceeded in the following manner. During the 90-day period before filing for bankruptcy, the debtor applied for a RAL from Household by filling out a form entitled "Loan Application, Authorization and Certification for a Refund Anticipation Loan." The debtor also established a bank account at Household for the sole purpose of electronically receiving a federal income tax refund. In addition, the debtor completed a Form 8453 consenting to have the IRS deposit his tax refund directly into the account with Household and, with the bank's helping hand, he designated a routing number and bank account number corresponding to that account on his return. At or

about the same time, the debtor was provided with two additional items--a disclosure document and a summary sheet.

The bankruptcy court rejected the trustees' pleas, concluding that the transactions resulted in money in the bank's pocket that was more appropriately considered a recoupment and that the bank came upon the funds in the ordinary course of business. *Warsco v. Household Bank F.S.B.*, 272 B.R. 246 (Bankr. N.D. Ind. 2002). The district court agreed with this determination when it rejected the trustees' appeal. We begin with a closer look at the mechanics of a RAL.

It is undisputed that the bank retained exclusive control over the RAL accounts and that no funds other than the tax refund were deposited into them. And the bank's exclusive control, of course, meant that the debtors could not get their hands on the funds once they reached the designated account. The undisputed facts also provide the following information about each individual RAL transaction: (1) the name and social security number of the debtor; (2) the loan application date, (3) the loan amount, (4) the date the loan check was issued, (5) the date the electronic fund transfer from the IRS was received into the debtor's account at the bank, and (6) the date the bank took control of the deposit. The parties have also stipulated, in each case, as to the date the bankruptcy petition was filed and the prior years, if any, when the debtor participated in the bank's RAL program. As to this point, it is noteworthy that only 15 of the more than 100 debtors in our case were first-time parties to RALs with Household. Lastly, the parties agree that all of the transfers were made in accordance with the ordinary business practices of parties engaged in the tax refund loan industry.

In responding to the trustees' claims, both below and here, the bank contends that each debtor made an absolute assignment of his tax refund or, alternatively, that it held a perfected security interest in the refund or its proceeds. As an affirmative defense to the preference claims, the bank asserts that the money it received is protected by the ordinary course of business defense under § 547(c)(2). It also characterizes each payment as a recoupment, rather than a setoff, which prevents the trustees from recovering the funds under § 553(b) or § 549(a).

Upon submitting an application, or perhaps a day later, the debtor received a check from **Household** in the amount of his anticipated federal tax refund, less **Household's** fee. Sometime thereafter, the IRS deposited the debtor's tax refund into the debtor's designated account at **Household**. **Household** then immediately transferred the funds to itself. It is this transfer, by which the **bank** actually received the money, that the trustees seek to avoid.

Section 547(b) of the Bankruptcy Code allows a trustee to avoid some payments to creditors made during the 90 days prior to bankruptcy. These payments are regarded as "preferential," and thus avoidable, because they allow the favored creditor to receive more than if he had to wait in line with other creditors and share with them what is usually rather slim pickings from the debtor's estate. The purpose of this section is two-fold. It is designed to promote equality of distribution among all creditors while simultaneously it deters creditors from "racing to the courthouse to dismember the debtor during [his] slide into bankruptcy," *Union Bank v. Wolas*, 502 U.S. 151, 161, 116 L. Ed. 2d 514, 112 S. Ct.

527 (1991). *See also In re Milwaukee Cheese Wis.*, Inc., 112 F.3d 845, 847 (7th Cir. 1997).

But not all payments to creditors during the 90 days prior to bankruptcy are avoidable preferential transfers. In crafting § 547, Congress created exceptions protecting certain transfers from a trustee's reach. *See* 11 U.S.C. § 547(c). Among them is the "ordinary course of business" exception. Where a transfer is (a) "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, (b) "made in the ordinary course of business or financial affairs of the debtor and the transferee," and (c) "made according to ordinary business terms," it is insulated from avoidance. *See* 11 U.S.C. § 547(c)(2)(A)-(C). This exception was designed to "leave undisturbed normal commercial and financial relationships and protect recurring, customary credit transactions which are incurred and paid in the ordinary course of business of both the debtor and the debtor's transferee." *See In re Armstrong*, 231 B.R. 723, 729 (Bankr. E.D. Ark. 1999), *aff'd*, 260 B.R. 454 (E.D. Ark. 2001). These transactions are not considered "preferential," although they would otherwise fit comfortably within the statutory definition. The creditor has the burden of proving that the debtor's payment to it qualifies for this protection. *See* 11 U.S.C. § 547(g).

We have examined the ordinary course of business defense on several occasions. *See, e.g., Barber v. Golden Seed Co.*, 129 F.3d 382 (7th Cir. 1997); *In re Milwaukee Cheese Wis., Inc.*, 112 F.3d 845 (7th Cir. 1997); *In re Midway Airlines, Inc.*, 69 F.3d 792 (7th Cir. 1995); *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029 (7th Cir. 1993). And we must consider whether the transaction, the RAL here, was

"ordinary" not only as between the debtor and the bank, but also in the context of how the RAL industry operates as a whole. *See Midway Airlines*, 69 F.3d at 797. Because it is undisputed that the transactions were "ordinary" within the tax refund loan industry, if they were also ordinary as between Household and the individual debtors, they are not avoidable preferences. In making this determination we consider several factors, including:

> (1) the length of time the parties were engaged in the transaction at issue;
> (2) whether the amount or form of tender differed from past practices;
> (3) whether the debtor or creditor engaged in any unusual collection or payment activity; and
> (4) whether the creditor took advantage of the debtor's deteriorating financial condition.

Barber, 129 F.3d at 390. This is not an exhaustive list of factors. Others, in appropriate considerations, may be a better fit.

In our case, where the debtor was a prior RAL customer of the bank, that history persuades us that the transactions challenged were ordinary as between Household and the debtor because they occurred in the same manner and under the same circumstances as in prior years. Where, however, the challenged transaction was the first RAL between the parties, a closer question is presented.

We have not directly addressed this "first-time" issue but other courts have, with mixed results, although most side with the view that a first-time transaction is not per se ineligible for

protection from avoidance under § 547(c)(2). *Compare In re Finn,* 909 F.2d 903 (6th Cir. 1990); *In re Russell Cave Co.,* 259 B.R. 879 (Bankr. E.D. Ky. 2001); *In re Air South Airlines,* 247 B.R. 165 (Bankr. D. S.C. 2000); *In re Armstrong),* 231 B.R. 723 (Bankr. E.D. Ark. 1999), *aff'd,* 260 B.R. 454 (E.D. Ark. 2001); *In re Morren Meat & Poultry Co.,* 92 B.R. 737 (W.D. Mich. 1988) (a first-time transaction can qualify as a payment in the ordinary course of business) *with In re Brown Transp. Truckload, Inc.*, 152 B.R. 690 (Bankr. N.D. Ga. 1992) (a first-time transaction is categorically ineligible for protection as payment in the ordinary course of business).

Although a history of dealing between parties is certainly the strongest factor supporting a determination that the business between a debtor and an alleged preference creditor is ordinary, we do not believe it is absolutely necessary in every case. In some instances, and this is one, the ordinary course of business may be established by the terms of the parties' agreement, until that agreement is somehow or other modified by actual performance. In the absence of modifying behavior, we see no reason why we should not look to the terms of the parties' agreement in order to determine their ordinary course of business. Indeed, as Judge Grant in the bankruptcy court astutely observed here,

> the court can imagine little (short of the certain knowledge that its debt will not be paid) that would discourage a potential creditor from extending credit to a new customer in questionable financial circumstances more than the knowledge that it would not even be able to raise the ordinary course of

business defense, if it is subsequently sued to recover an alleged preference.

In our case, every RAL transaction, including the first-time transactions between Household and a particular debtor, was conducted in accordance with the terms of the parties' written agreement. This included the timing and the manner in which Household applied the funds from each debtor's account to the loan balance. We conclude that all of the transactions were ordinary as between the parties. Because each transaction was ordinary as between the parties and when measured against the tax refund loan industry as a whole according to ordinary business terms, they are insulated from avoidance under § 547(c)(2).

In closing, we comment on one final matter. The trustees argue that RALs actually involve two separate transactions. In the first, the debtor applies for a tax refund with the IRS. In the second, the bank makes a loan to the debtor. Viewed this way, the trustees see a setoff. The reality of a RAL process, however, is more accurately viewed as a single integrated transaction. And because Household held title to the funds when they were received at the bank and then transferred to the bank's own account, the bank was not engaging in "setting off" a debt owed by the debtor.

The judgment of the district court is AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF INDIANA
FORT WAYNE DIVISION

Case No. 1:02 CV 26

[Filed July 26, 2002]

YVETTE GAFF KLEVEN, Trustee,	)
MARK A. WARSCO, Trustee,	)
DAVID R. DUBOIS, Trustee,	)
Appellants,	)
	)
v.	)
	)
HOUSEHOLD BANK F.S.B.,	)
Appellee.	)
	)

AMENDED JUDGMENT IN A CIVIL CASE

[ ] Jury Verdict. This action came before the court for a trial by jury, The issues have been tried and the jury has rendered its verdict.

[x] Decision by Court. This action came to trial, hearing or consideration before the Court. The issues have been tried, heard or considered and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the January 15, 2002, decision of the Bankruptcy Court is affirmed for this case and for all 98 consolidated appeals, as ordered by this court's order of February 7, 2002.

Stephen R. Ludwig, Clerk

By /s/_____
Kathy Wright, Deputy Clerk

Equivalent Coupon issue Yield 1.97%
This document entered pursuant to Rules 79(a) and 58 of the Federal Rules of Civil Procedure on July 26, 2002.

APPENDIX C

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF INDIANA
FORT WAYNE DIVISION

Case No. 1:02 CV 26

[Filed July 26, 2002]

YVETTE GAFF KLEVEN, Trustee,	)
MARK A. WARSCO, Trustee,	)
DAVID R. DUBOIS, Trustee,	)
Plaintiffs,	)
	)
v.	)
	)
HOUSEHOLD BANK F.S.B.,	)
Defendant.	)
	)

ORDER

This is an appeal from a final judgment of the United States Bankruptcy Court for the Northern District of Indiana, Fort Wayne Division, entered January 15, 2002. Jurisdiction to hear and determine this appeal is granted by 28 U.S.C. § 158(a)(1), and Bankruptcy Rule 8001.

This appeal was filed on January 29, 2002 and the parties completed briefing the appeal on June 20, 2002. For the following reasons, the decision of the Bankruptcy Court will be affirmed.

Discussion

In its order dated January 15, 2002, the Bankruptcy Court dismissed various consolidated adversary proceedings brought by the Trustees herein against Household Bank, F.S.B., ("the Bank") and granted judgment in favor of the Bank. The relevant factual background is as follows.

The Bank issued Refund Anticipation Loans ("RALs") to the Debtors solely in anticipation of, and to be paid by, the Debtors' federal income tax refund proceeds. The Debtors filed a Chapter 7 petition within ninety days of each Debtor's RAL Application. The Trustees sought to avoid the repayment of these RALs either as improper setoffs or, alternatively, as preferential transfers. The Bankruptcy Court held that the repayment of the Debtors' RAL debts constituted unavoidable acts of recoupment, and further held that the debts were non-avoidable as payments in the ordinary course of business.

With respect to recoupment, the Bankruptcy Court noted that each RAL loan was extended in an integrated transaction in which, at the very time the loan was made, each Debtor irrevocably authorized the IRS to deposit his or her federal tax refunds into a special purpose account at the Bank, which account was set up for the sole purpose of repaying the Debtor's RAL obligation. Based on these facts, the Bankruptcy Court reasoned that the application of the tax refund to each individual Debtor's loan balance "was part and

parcel of a single integrated transaction -- the loan to the debtor, along with the establishment of a deposit account which would receive the debtor's income tax refunds, and the subsequent creation of a corresponding debt when the refund was deposited into that account, which was then used to satisfy the debtor's obligation." Warsco v. Household Bank F.S.B., 272 B.R. 246, 253 (Bankr. N.D. Ind. 2002). Thus, the Bankruptcy Court held that the transactions constituted unavoidable "recoupments". In support of their appeal, the Trustees argue that the Bankruptcy Court erred as a matter of law, and that the transactions were not unavoidable recoupments.

In general, recoupment "is the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim." In re University Med. Ctr., 973 F.2d 1065, 1079 (3d Cir. 1992) (quoting 4 Collier on Bankruptcy § 553.03, at 553-15-17). The federal courts have adopted two separate approaches to determine whether the "same transaction" test is met in the bankruptcy context. The Third Circuit has articulated the more strict approach, stating that "a mere logical relationship [between the obligators] is not enough." University Med. Ctr., 973 F.2d at 1081. "Rather, both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." Id. Although the Seventh Circuit has not yet decided whether it would apply the Third Circuit's test, the Bankruptcy Court for the Northern District of Illinois has predicted that the Seventh Circuit would apply the Third Circuit's test. In re St. Francis Physician Network, Inc., 213

B.R.710 (Bankr. N.D. Ill. 1997). This court will also apply the Third Circuit's "single integrated transaction" test.

The Trustees have taken the position that the funding of the RAL loans and the repayment of the RAL loans were two separate transactions. The Trustees contend that the event which gave rise to each RAL loan was the extension of credit by the Bank, whereas the events which gave rise to the repayment of the loan involve the refund of the Debtors' excess withholdings by the IRS. The Trustees claim that the events which gave rise to the repayment have nothing to do with the events which gave rise to the loan.

The Bank, however, contends that the RALs were extended, and the debts were incurred, solely in anticipation of payment by receipt of the tax refunds. Thus, according to the Bank, the granting of the loan was inextricably linked to the payment through receipt of the refund into special purpose accounts. The Bank points out that it would not have issued the RALs if the Debtors were not entitled to tax refunds, did not file their tax returns electronically, and did not authorize automatic payment of the RALs by transfers of the tax proceeds to the Bank upon deposit by the IRS. Thus the Bank argues that the loans and the payment thereof arose out of single integrated transactions and that it would be inequitable for the Debtors to receive the loan proceeds without making payment as contemplated by the loan documents.

The Bank concludes that the RALs are the quintessential example of recoupment, and that the mutual contractual obligations qualify as a single integrated transaction. See In re Flagstaff Realty Assoc., 60 F.3d 1031 (3d Cir. 1995) (holding that a tenant's claim for repair costs and the landlord's claim

for lease payments arose out of the same lease and are subject to recoupment); In re Trans World Airlines, Inc., 275 B.R. 712 (Bankr. D. Del. 2002); In reTelephone Warehouse, Inc., 259 B.K. 64, 67-68 (Bankr. D. Del. 2001).

The Trustees, however, claim that the repayment of the RAL loan is not a recoupment, but an avoidable set-off. The Trustees rely on In re Anes, 195 F.3d 177 (3d Cir. 1999), and Pereira v. Summit Bank, 2001 WL 180022(S.D.N.Y. (Pereira I) vacated and superseded by Pereira v. Summit Bank, 2001 WL 563730 (S.D.N.Y. 2001) (Pereira II). A review of these two cases reveals that there were no mutual, mirror contractual obligations involved. In Anes, the debtors obtained loans prior to retirement based on the value of their retirement benefits, which loans were to be repaid by deductions from their paychecks. If the debtors failed to repay the loans, the loans would be repaid by a deduction from the debtors' retirement accounts. The debtors argued that the retirement system could continue to deduct the repayments from their postpetifion paychecks under the doctrine of recoupment. However, the Third Circuit found that the debtors' obligation to repay the loan was separate from the obligation of the employer to pay the debtors for their postpetition employment services. 195 F.3d at 182-83. Thus, there was no single integrated transaction and no recoupment.

In Pereira, the debtor maintained a checking account at a bank. While engaging in a check kiting scheme, the debtor incurred a large obligation to the bank, overdrawing the account by more than $20 million. The bank froze the debtor's account, and credited deposits made to the account against the obligation caused by the debtor's fraud. The Pereira Court held that this was a setoff, and not a

recoupment, as the repayment of the credit did not arise out of a single integrated transaction. In fact, the bank was not even aware that the debtor was incurring an obligation, as it was not aware of the kiting scheme.

In the present case, it is clear that the Bank would not have funded the loans absent the Debtors' irrevocable agreement to have their income tax refund proceeds deposited in a special purpose bank account to which the Debtors had no access. Clearly, the Debtors' contractual obligation to have the tax refund proceeds deposited into accounts at the Bank was the consideration that persuaded the Bank to fund the RALs and arose out of the same integrated transaction. Consequently, this court agrees with the Bankruptcy Court's ruling that the Bank's crediting of the tax refund amounts to the RALs constitutes recoupment.

The Bankruptcy Court also held that the transactions at issue were made in the ordinary course of business, and thus were not avoidable preferences under § 547. Section 547 of the Bankruptcy Code allows a trustee to avoid some payments to creditors made during the ninety days prior to bankruptcy. However, not all payments made to creditors during the ninety days prior to bankruptcy are considered to have been preferential. Rather, there are exceptions which protect some transfers from the trustee's reach. See 11 U.S.C. § 547(c). Among them is the "ordinary course of business" exception. Where a transfer is (a) "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee," (b) "made in the ordinary course of business or financial affairs of the debtor and the

transferee," and (c) "made according to ordinary business terms," the transfer is insulated from avoidance.[1]

As the result of stipulations by the parties that the transactions were ordinary within the tax refund loan industry, the only issue is whether the transfers were also ordinary as between the Bank and the Debtors. The Bankruptcy Court held that "[i]n this case, where the debtor was a prior customer of the defendant, with a history of applying for, receiving, and repaying refund anticipation loans, that history persuades the court that the transactions challenged here were ordinary as between Household and the debtor because those transactions occurred in the same manner and under the same circumstances as in prior years." 272 B.R.246, 251 (Bankr. N.D. Ind. 2002). As the Bankruptcy Court noted, the factors to be considered when determining whether a transaction occurred within the "ordinary course" include:

> (1) the length oft/me the parties were engaged in the transactions at issue: (2) whether the amount or form

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[1] The Trustees assert that the Assignment of Claims Act, 31 U.S.C. § 3727(b), sets forth what is "ordinary" with respect to assigning fights in a federal income tax refund. The Trustees' assertion is incorrect. The Assignment of Claims Act provides that a claim against the government may be assigned only after the claim is allowed. This provision protects the federal government. Thus, while the Bank could not enforce the right to receive the tax proceeds against the government, it could nevertheless enforce the assignment against the Debtors. Segal v. Rochelle, 382 U.S. 375, 384 (1966); In re Martin, I67 B.R. 609, 614 (Bankr. D. Or. 1994); In re Richardson, 216 B.R. 206, 214 (Bankr. S.D. Ohio 1997).

> of tender differed from past practices, (3) whether the debtor or creditor engaged in any unusual collection or payment activity, and (4) whether the creditor took advantage of the debtor's deteriorating financial condition.

Id. (citing In re Grand Chevrolet, Inc., 23 F.3d 728, 732 (9th Cir. 1994).

There is no dispute that the RAL transactions at issue followed the typical RAL procedure: the loan was provided to the Debtors aider completion of the Debtors' income tax return and submission of the RAL documents, and payment was made through receipt of the Debtors' income tax refund proceeds into special purpose accounts. The transactions did not differ from past practices and the parties did not engage in any unusual payment activities. Additionally, there is no evidence that the Bank took advantage of the Debtors' financial condition or that the Bank was even aware of the general financial condition of any of the Debtors. Thus, with respect to the Debtors who previously obtained RALs, this court agrees with the Bankruptcy Court that the transactions were "ordinary".[2]

With respect to the "first-time" RAL Debtors, the Bankruptcy Court looked to the terms of the contract. In the present eases, for those Debtors who had not previously obtained RALs, the RAL agreement sets forth the ordinary

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[2] Of the 98 cases consolidated herein, 80 Debtors have used the RAL loan process with the Bank on at least one prior tax year. Many have engaged in multiple RAL transactions over the years.

course of business agreed upon by the parties. The Bank and the Debtors followed the contract terms exaetly. The law is clear that an isolated or first time transaction may be in the ordinary course of business or financial affairs of the debtor and the transferee. In re Finn, 909 F.2d 903 (6th Cir. 1990); In re Russell Cave Co., 259 B.R. 879 (Bankr. E.D. Ky. 2001); In re Air South Airlines, 247 B.R.165 (Bankr. D.S.C. 2000); In re Armstrong, 231 B.R. 723 (Bankr. E.D. Ark. 2001); In re Morren Meat & Poultry Co., 92 B.R. 737 (W.D. Mich. 1988). The law also provides that the parties can establish the ordinary course for first time transactions by the terms of their agreement. In re Russell Cave, 259 B.R. at 884 (recognizing that "every borrower who does something in the ordinary course of her affairs must, at some point, have done it for the first time," and holding that the court should "give sufficient weight to the terms the parties agreed to where there is no history demonstrating their disregard of the payment terms set out ...."); In re Air South, 247 B.R. at 172 (holding that, for first time transactions, the court should look at the terms of the agreement to determine ordinary course and consider whether any other unusual conduct took place).

In light of these authorities, this court finds that the Bankruptcy Court correctly held that the first-time RAL transactions, as well as the recurring RAL transactions, were ordinary as between the parties and thus insulated from avoidance by § 547(c)(2). Accordingly, the decision of the Bankruptcy Court will be affirmed.

Conclusion

On the basis of the foregoing, the decision of the Bankruptcy Court is hereby

AFFIRMED.

Entered: July 26, 2002.

/s/_____
William C. Lee, Chief Judge
United States District Court

APPENDIX D

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
FORT WAYNE DIVISION

Consolidated Under
Adv. Proc. No. 01-1085

[Filed January 15, 2002]

IN RE: VARIOUS CASES	)
	)
MARK A. WARSCO, Trustee, et al.	)
Plaintiffs,	)
	)
v.	)
	)
HOUSEHOLD BANK F.S.B.,	)
Defendant.	)
	)

DECISION

At Fort Wayne, Indiana, on January 15, 2002

One hundred six separate adversary proceedings[1] have been consolidated for the purpose of submitting them to the court for a decision. See, Fed.R.Civ.P.Rule 42(a); Fed. R. Bankr. P. Rule 7042. All of them present the question of whether the plaintiffs, who are the trustees of different chapter 7 bankruptcy estates, may recover payments made to the defendant, Household Bank. These payments were made either shortly before or soon after the date of the petition initiating each debtor's bankruptcy. Plaintiffs contend they constitute recoverable setoffs, see, 11 U.S.C. § 553(b), preferential transfers, see, 11 U.S.C. § 547(b), or impermissible post-petition transfers of property of the estate, recoverable under 11 U.S.C. § 549(a). Those issues have been submitted to the court for a decision basedupon the parties' stipulation of facts and the briefs of counsel.

FACTS

Each of the transactions giving rise to Plaintiffs' claims proceeded in the following manner. During the ninety days before filing bankruptcy, the debtor applied for a retired anticipation loan from Household by filling out a form entitled "Loan Application, Authorization and Certification for a Refund Anticipation Loan." When it submitted this application, the debtor also established a bank account at Household for the Sole purpose of electronically receiving the debtor's federal income tax refund. The debtor also completed a Form 8453, consenting for the IRS to deposit its tax refund

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[1] Adversary proceedings 01-1013 thru 01-1104, 01-6026 thru 01-6041, 01-6044 and 01-6045; of them, three (01-1072, 01-1079, and 01-1089) have been dismissed.

directly into the account with Household and, on lines 66(b) and 66(d) of its federal tax return (Form 1040), designated a routing number and bank account number corresponding to that account. At or about the same time, the debtor was provided with two additional documents: a disclosure document and a summary sheet.

Within a day or two after submitting its application, the debtor received a loan check from Household in the amount of the debtor's anticipated federal tax refund, less Household's fee for the loan. Sometime thereafter, the IRS deposited the debtor's tax refund into the account the debtor had established at Household. Household then immediately transferred the funds so deposited to itself.[2] It is this transfer, by which the defendant received payment of the amounts due it, that Plaintiffs seek to avoid.

The parties agree that, at all times, Household retained exclusive possession and complete control over the designated accounts. No funds other than the tax refund were ever deposited into those accounts and the debtors had no access to or ability to withdraw funds from them. The stipulated facts also provide the following information about each individual transaction: (1) the name and social security number of each debtor, (2) the loan application date, (3) the loan amount, (4) the date the loan check was issued, (5) the date the electronic fund transfer from the IRS was received in the debtor's account, (6) the date Household posted the refund, (7) the

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[2] If the refund exceeded the amount due from the debtor, Household issued the debtor a check for the difference. If the refund was less than the amount due, the debtor owed the difference to Household.

bankruptcy petition date, and, finally, (8) the prior years, if any, in which the respective debtor participated in Household's refund anticipation loan program. Lastly, the parties agree that all of the transfers were made in the ordinary course of Household's business or financial affairs and were made in accordance with the ordinary business terms of parties in the tax refund loan industry.

In response to the trustees' claims, Household contends that each debtor made an absolute assignment of its tax refund or, alternatively, that it held a perfected security interest in the refund or its proceeds. As an affirmative defense to the preference claims, it asserts that the payments it received are protected by the ordinary course of business defense of § 547(c)(2). It also characterizes each payment as recoupment, rather than a setoff, which would prevent the trustees from recovering anything under § 553(b) or § 549(a).

DISCUSSION

The court finds two of Household's arguments persuasive. If the individual transfers are analyzed as preferences under § 547, they were made in the ordinary course of business. Furthermore, rather than constituting a preferential transfer or an impermissible setoff, the transfers in question are properly characterized as recoupment. Because of these conclusions, it is not necessary to consider the other issues raised by either party.

Section 547(b) of the Bankruptcy Code allows a trustee to avoid some payments to creditors made during the ninety days pdor to bankruptcy. These payments are regarded as preferential because they allow the creditor to receive more

than it otherwise would absent the transfer. The purpose of this section is two-fold. It is designed to promote equality of distribution among all creditors of the debtor, while, simultaneously, it deters creditors from "racing to the courthouse to dismember the debtor during [its] slide into bankruptcy," Union Bank v. Wolas, 502 U.S. 151,161, 112 S. Ct. 527, 533 (1991), by eliminating the fruits of such a race. In re Milwaukee Cheese Wisconsin, Inc., 112 F.3d 845, 847 (7th Cir. 1997).

Not all payments made to creditors during the ninety days prior to bankruptcy are considered to have been preferential. In crafting § 547, Congress also created exceptions protecting some transfers from the trustee's reach. See, 11 U.S.C. § 547(c). Among them is the "ordinary course of business" exception. Where a transfer is (a) "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee," (b) "made in the ordinary course of business or financial affairs of the debtor and the transferee," and (c) "made according to ordinary business terms," the transfer is insulated from avoidance. See, 11 U.S.C. § 547(c)(2)(A)-(C). This exception was designed to "leave undisturbed normal commercial and financial relationships and to protect recurring, customary credit transactions which are incurred and paid in the ordinary coarse of business of both the debtor and the debtor's transferee." See, In re Armstrong, 231 B.P,723,729 (Bankr. E.D. Ark. 1999), aff'd, 260 B.P,. 454 (E.D. Ark. 2001). Such transactions are not considered preferential, even though they would otherwise fall within the statutory definition. The creditor has the burden of proving that the debtor's payment to it qualifies for this protection. See, 11 U.S.C. § 547(g).

The Seventh Circuit has examined the ordinary course of business defense on several occasions. See. e.g., Barber v. Golden Seed Co., Inc., 129 F.3d 382 (7th Cir. 1997); In re Milwaukee Cheese Wisconsin, Inc., 112 F.3d 845 (7th Cir. I997); In re Midway Airlines, Inc., 69 F.3d 792 (7th Cir. 1995); In re Tolona Pizza Prod., Corp., 3 F.3d 1029 (Tth Cir. 1993). These decisions provide a clear path for this court to follow. The court must determine whether the transaction was ordinary not only as between the parties but also in the industry examined as a whole. See, Midway Airlines, 69 F.3d at 797. In this case, however, the parties have stipulated that the transactions were ordinary within the tax refund loan industry. Consequently, if they were also ordinary as between Household and the individual debtors, they are not avoidable preferences.

To determine whether transfers were ordinary as between a debtor and a preference defendant courts have traditionally examined a variety of factors including:

(1) the length of time the parties were engaged hi the transaction at issue;

(2) whether the amount or form of tender differed from past practices;

(3) whether the debtor or creditor engaged in any unusual collection or payment activity;
and,

(4) whether the creditor took advantage of the debtor's deteriorating financial condition. Barber v. Golden

Seed Co., Inc., 129 F.3d 382, 390 (7th Cir. 1997) (citations omitted).

This list is not necessarily exhaustive but merely illustrative of appropriate considerations.

In this case, where the debtor was a prior customer of the defendant, with a history of applying for, receiving, and repaying refund anticipation loans, that history persuades the court that the transactions challenged here were ordinary as between Household and the debtor because those transactions occurred in the same manner and under the same circumstances as in prior years. Where, however, the challenged transaction was the furst refund anticipation loan between the parties, the question requires a somewhat different analysis, confronting the issue of whether a single isolated transaction can qualify for the ordinary course of business defense of §547(c)(2).

The court is not aware of any Seventh Circuit decisions which directly address this issue and the cases from other jurisdictions are divided. Compare In re Finn, 909 F.2d 903 (6th Cir. 1990); In re Russell Cave Co., Inc., 259 B.R. 879 (Bankr. E.D. Ky. 2001); In re Air South Airlines, 247 B.R. 165 (Bankr. D. S.C. 2000); In re Armstrong, 231 B.R. 723 (Bankr. E.D. Ark. 1999), aff'd, 260 B.R. 454 (E.D.Ark. 2001); In re Morren Meat & Poultry Co., Inc., 92 B.R. 737 (W.D. Mich. 1988) (a first time transaction can qualify as a payment in the ordinary course of business) with, In re Brown Transport Truckload, Inc., 152 B.R. 690 (Bankr. N.D. Ca. 1992) (a first time transaction is categorically ineligible for protection as payment in the ordinary course of business). As this list suggests, it appears that the majority of courts

considering the question have concluded that an isolated or first time transaction is not per se ineligible for protection from avoidance under section 547(c)(2). See also, In re Midway Airlines, Inc., 180 B.R. 1009, 1015 (Bankr. N.D. Ill. 1995). After carefully reviewing these decisions, the court agrees with this approach and with the conclusion that an isolated or frost time transaction be in the ordinary course of business or financial affairs of the debtor and the transferee.

Although a prior course of dealing between the parties would aid the court's determination concerning the ordinary course of business between a debtor and a preference defendant, and where available it is appropriately considered, it should not be an absolute necessity to the defense. Morren Meat, 92 B.R. at 740. Rather, the ordinary course of business may also be established by the terms of the parties' agreement. The parties have the opportunity to define the terms of their world, and, at least initially, they do so via their agreement. Over time, however, their actual performance of those contractual commitments may differ from what was originally agreed upon and, if it does, the course of conduct demonstrated by that historical performance will supercede the terms of their agreement. Over time, however, their actual performance of those contractual commitments may differ from what was originally agreed upon and, if it does, the course of conduct demonstrated by that historical performance will supercede the terms of their agreement. Cf., I.C. 26-1-2-202(a); I.C. 26-1-2-208(1) (a course of conduct may explain or supplement the terms of an agreement). Then - apparently based upon the proposition that actions speak louder than words - history rather than the terms of the parties' agreement, will determine the ordinary course of business between them. Nonetheless, in the absence

of such a history, there seems to be no good reason not to look to the terms of the parties' agreement in order to determine their ordinary course of business.[3] See, In re Russell Cave Co., Inc., 259 B.R. 879, 883-84 (Bankr. E.D. Ky.2001) (where parties' history begins with the transaction sought to be avoided, the court should give sufficiency weight to the terms of the parties' agreement). See also, Air South Airlines, 247 B.R. at 172 (citing Payne v. Clarendon Nat'Ins. Co. (In re Sunset Sales, Inc.), 220 B.R. 1005, 1021 (10th Cir. BAP 1998). To the extent that part of the rationale behind § 547(c)(2) is to encourage creditors to continue to do business with a potential debtor, see, In re Classic Drywall, Inc., 121 B.R. 69, 75 (D. Kan. 1990); In re Morren Meat & Poultry Co., Inc., 92 B.R.737, 740 (W.D. Mich. 1988); In re Ladera Heights Comm. Hospital. Inc., 152 B.R. 964, 968 (Bankr. C.D. Cal. 1993); In re Decor Noel Corp., 134 B.R. 868,875 (W.D. Tenn. 1991), doing so is entirely consistent with that policy. Indeed, the court can imagine little (short of the certain knowledge that its debt will not be paid) that would discourage a potential creditor from extending credit to a new customer in questionable financial circumstances more than the knowledge that it would not oven be able to raise the ordinary course of business defense, if it is subsequently sued to recover an alleged preference.

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[3] The requirement of § 547(c)(2)(C) that the transfer be "made according to ordinary business terms" and, thus, must fall within the range of practices acceptable to the particular industry, see, Tolona Pizza, 3 F.3d at 1032-33, places a limit on what the parties may agree to. It will prevent them from agreeing that "anything goes" and, by doing so, attempting to insulate all transfers to the creditor from avoidance.

Each transaction at issue, including the first-time transactions between Household and aparticular debtor, was conducted strictly in accordance with the terms of the parties' written agreement. This included the timing and the manner in which Household applied the funds from each debtors' account to the loan balance. Consequently, the court concludes that even the first-time transactions wore ordinary as between the parties. Because each transaction was ordinary as between the parties and, when measured against the tax refund loan industry as a whole, according to ordinary business terms, they are insulated from avoidance by § 547(c)(2).

When the transactions between the debtors and the defendant are analyzed, not as preferential transfers under § 547, but as setoffs under § 553(b),[4] the court concludes that they constitute unavoidable recoupments. Section 553 generally preserves the common law right of setoff after bankruptcy, see, 11 U.S.C. § 553(a), although the creditor's ability to do so is subject to the automatic stay. 11 U.S.C. § 362(a)(7). Prepetition setoffs, which occur during the 90 days prior to bankruptcy and allow a creditor to improve its position, may, however, be avoided, see, 11 U.S.C. § 553(b), in much the same way that § 547 allows the avoidance of payments made to creditors during that same period of time. Although § 553(b) condemns pre-petifion setoffs which allow a creditor to improve its position, its provisions do not apply

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[4] By definition, a transfer does not include a setoff, 11 U.S.C § 101 (54), and the legislative history indicates that the exclusion was intentional. See, 124 Cong. Rec. H11090 (daily ed. Sept. 28, 1978); S 17407 (daily ed. Oct. 6, 1978) (remarks of Rap. Edwards and Sen. DeConcini)

to recoupments. See, In re Malinowski, 156 F.3d 131, 133 (2d Cir. 1998); In re University Medical Center, 973 F.2d 1065, I080 (3rd Cir. 1992). This is true even though the recoupment permits the creditor to obtain otherwise preferential treatment. See, In re Kosadnar, 157 F.3d 1011, 1014 (5th Cir. 1998).

It is often difficult to distinguish between a permissible recoupment and an impermissible setoff. Their fundamental distinction turns upon whether the mutual debts arose out of the same or separate transactions. See, In re TLC Hospitals, Inc., 224 F.3d 1008, 1011 (9th Cir. 2000). Where mutual debts "arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations;" the creditor's apparent offset is really recoupment. Malinowski, 156 F.3d at 133 (emphasis added) (citations omitted).

The transfer ofthe proceeds from each debtor's individual deposit account to Household was part and parcel of a single integrated transaction - the loan to the debtor, along with the establishment of a deposit account which would receive the debtor's income tax refunds, and the subsequent creation of a corresponding debt when the refund was deposited into that account, which was then used to satisfy the debtor's obligation. Therefore, Households' actions constituted recoupment and not a setoffwhich can be recovered by the Plaintiffs through § 553(I)). Furthermore, unlike setoff, recoupment is not subject to the automatic stay of § 362. Kosadnar, 157 F.3d at 1015; Malinowski, 156 F.3d at 133. Consequently, Defendants' actions do not constitute an unauthorized post-petition transfer that Plaintiffs can recover through § 549.

CONCLUSION

If the transfer of the proceeds from each debtors' deposit account to Household is viewed as a preference, Household has demonstrated that these transfers are protected by the ordinary course of business defense of 11 U.S.C. § 547(c)(2). When analyzed under § 553, Household's application of the funds in each debtors' account was a recoupment and not a setoff or an otherwise unauthorized post-petition transfer. As a result, none of the transfers can be recovered by the Plaintiffs. A judgment of dismissal will be entered.

/s/
Judge, United States Bankruptcy Court

A copy of the attached sent first class U.S. Mail on January 15, 2002 to:

US Trustee, 1 Michiana Sq. Room 555, 100 E. Wayne St., South Bend, IN 46601 Mark Warsco, 110 W. Berry St., PO Box 11647, Fort Wayne, IN 46859, Charles Carpenter, Hamilton Square, 600 14th Street NW, Washington, DC 20005 David R. Dubois, Trustee, 2545 Portage Mail, P O Box 14, Portage IN 46368 Yvette Gaff Kleven, Suite 100, 230 W. Main St., Fort Wayne, IN 46802-1612, R. David Boyer, 300 Metro Bldg., Fort Wayne, IN 46802.

APPENDIX E

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
FORT WAYNE DIVISION

Adv.Proc.No. 01-1013 thru 01-1104
Adv.Proc.No. 01-6026 thru 01-6041
Adv.Proc.No. 01-6044
Adv.Proc.No. 01-6045

[Filed July 13, 2001]

IN RE VARIOUS CASES

MARK A. WARSCO, Trustee,	)
YVETTE GAFF KLEVEN, Trustee,	)
R. DAVID BOYER, Trustee	)
DAVID R. DUBOIS, Trustee,	)
Plaintiffs,	)
	)
v.	)
	)
HOUSEHOLD BANK F.S.B.,	)
Defendant.	)
	)

STIPULATIONS OF FACT AND LAW WITH REGARD TO CONSOLIDATED ADVERSARY PROCEEDINGS

Bankruptcy Court -- Stipulations of Fact and Law - dated July 13, 2001

COME NOW Plaintiff Trustees, Mark A. Warsco, R. David Boyer, Yvette Gaff Kleven, and David R. DuBois (collectively "Trustees") by counsel, and Defendant Household Bank F.S.B. ("Household"), by counsel, and for their stipulations required by the Court's Order of April 20, 2001, state as follows:

1. This Court has jurisdiction over the consolidated adversary proceedings pursuant to 28 U.S.C. §§ 157 and 1334.

2. The Trustees are the duly appointed and acting Trustees in the respective bankruptcy cases in which the consolidated adversary proceedings were filed.

3. Each of the consolidated adversary proceedihgs arises from a Refund Anticipation Loan ("RAL") transaction between the Debtor(s) and Household. Although there is some variation among circumstances in the transactions, the following is a general description of the steps-involvedin the subject RAL transactions:

a. The Debtor makes an application for an RAL. The loan applications are in the form attached hereto as Exhibit "A" or Exhibit "B".

b. At the time the Debtor makes his or her application for the RAL, the Debtor designates a routing number and account number on lines

66(b) and 66(d) of Form 1040 which describe an account set up at Household specifically to receive the refund called for in the Form 1040. The example form is attached hereto as Exhibit "C'.

c. In addition, the Debtor also completes a Form 8453, consenting to the refund being directly deposited in the designated account. See the example form attached hereto as Exhibit "D".

d. On or about the date of the RAL application, the Debtor is provided with two additional documents by Household and/or its duly authorized agent: the disclosure document in the form attached hereto as Exhibit "E" and the summary sheet in the form attached hereto as Exhibit "F".

e. Once the application is made, Household decides whether to extend credit to the Debtor. If it decides to do so, Household issues a check within a day or two, to the Debtor in the amount of the tax refund, less fees (RAL amount).

f. Household then receives an electronic funds transfer ("EFT") from the Internal Revenue Service in the amount of the tax refund.

g. Household immediately transfers the funds from the account set up in the Debtor's name

to receive the EFT to its own account. If the tax refund exceeds the Debtor's RAL plus fees, Household issues a check to the Debtor. Otherwise, if the refund amount is less than the RAL plus fees, the Debtor owes the difference to Household.

h. Household retains exclusive possession and control over the account designated to receive the tax refund, and no funds other than the tax refund are ever deposited in the account. The Debtor never has access to, or the ability to withdraw funds from, the designated account.

i. Finally, the EFT is posted to the Debtor's RAL record.

4. In each of these cases, a Debtor has filed a Chapter 7 bankruptcy petition within ninety (90) days after the Debtor made his or her application for an RAL as the attached tables indicate. In some cases, the petition has been filed prior to Household receiving the EFT from the IRS.

5. In those cases where the bankruptcy petition was filed prior to Household receiving the EFT from the IRS, no authority was sought or obtained from the Bankruptcy Court for Household to receive the EFT from the IRS.

6. Pursuant to the parties' agreement described at the scheduling competence held on April 16, 2001, the Trustees' complaints shall be deemed amended to also include an allegation that the funds received by Household from thd IRS am avoidable pursuant to 11 U.S.C, § 553, in addition to the statutes already cited in the complaints filed in the consolida'ted adversary proceedings.

7. Attached hereto as Exhibits "G", "H", "I", "J", and "K" are tables of information relating to each of the consolidated adversary proceedings, including the following information:

   a. The name and social security number of each Debtor.

   b. The RAL application date.

   c. The actual RAL amount.

   d. The RAL check issuance date.

   e. The date the EFT from the IRS was received by Household. The date Household posted the refund.

   g. The bankruptcy petition date.

h. Prior years in which the respective Debtors participated in the RAL program, if any.

8. For purposes of the 11 U.S.C. § 547(c)(2) defense asserted by Household, a11 transfers made with respect to RAL transactions, such as those at issue in these consolidated adversary proceedings, were made in the ordinary course of Household's business or financial affairs and were made in accordance with the ordinary business terms of parties in the Tax Refund Loan industry.

9. The attached documents hereto are substantially similar to the forms used in all of the cases and are admissible as evidence herein as samples of such forms.

Respectfully Submitted,

/s/_____

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Exhibits A-K on file in the U.S. Supreme Court Clerk's Office

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No. 03-492

IN THE

Supreme Court of the United States

YVETTE GAFF KLEVEN, Trustee,
MARK A. WARSCO, Trustee, and
DAVID R. DUBOIS, Trustee,
Petitioners,

v.

- HOUSEHOLD BANK F.S.B.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of the Rules of the Supreme Court of the United States, Respondent respectfully submits this Corporate Disclosure Statement.

The interested parties are Household Finance Corporation, on behalf of named Respondent Household Bank F.S.B.; Household Finance Corporation is a wholly owned subsidiary of Household International, Inc., which is in turn a wholly owned subsidiary of HSBC Holdings plc., a publicly traded company.

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IN THE

Supreme Court of the United States

No. 03-492

YVETTE GAFF KLEVEN, Trustee,
MARK A. WARSCO, Trustee, and
DAVID R. DUBOIS, Trustee,
Petitioners,

v.

HOUSEHOLD BANK F.S.B.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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RESPONDENT'S BRIEF IN OPPOSITION

STATEMENT OF THE CASE

Petitioners, the Chapter 7 trustees for nearly 100 Debtors, filed adversary proceedings in each Debtor's bankruptcy case seeking to avoid a previous repayment of a loan each Debtor obtained from Respondent Household Bank F.S.B. Petitioners asserted three bases for avoidance, each tailored to a different characterization of the loan. First, Petitioners argued that if repayment of such a loan is a "setoff," each repayment would be avoidable under section 553 of the

Bankruptcy Code. Petitioners next argued that if such a repayment constitutes a "transfer,"[1] the pre-bankruptcy petition repayments would be preferences subject to avoidance under section 547(b) of the Bankruptcy Code, while section 549(a) of the Bankruptcy Code would subject post-bankruptcy petition repayments to avoidance.

The bankruptcy court rejected all three claims. It found that when repayment of a tax refund anticipation loan ("RAL") is considered a setoff, the repayment constitutes a recoupment and thus would not be avoidable by Petitioners. Alternatively, if the RAL repayment is considered a transfer, it nonetheless would be unavoidable because such payments were made in the ordinary course of business and therefore would be exempted from avoidance by section 547(c)(2) of the Bankruptcy Code. The district court affirmed on the same two grounds. The court of appeals affirmed both grounds accepted by the district court and adopted a third argument advanced by Respondent: the Debtors assigned their beneficial interests in the tax refunds to Respondent at the outset of the RAL processes, precluding reliance on any of the avoidance theories propounded by Petitioners.

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[1] The terms "transfer" and "setoff" are, in this context, mutually exclusive. 124 Cong. Rec. 32,393 (1978) (noting the explicit exclusion of the word setoff from the definition of the term transfer and stating that a "'setoff' is not subject to being set aside as a preferential 'transfer' but will be subject to special rules."); *see In re Dillard Ford, Inc.*, 940 F.2d 1507, 1512 (11th Cir. 1991); *Lee v. Schweiker*, 739 F.2d 870, 873 n.4 (3d Cir. 1984); *In re Brooks Farms*, 70 B.R. 368, 372-73 (Bankr. E.D. Wis. 1987); *In re Hinson*, 65 B.R. 675, 677 (Bankr. W.D. Tenn. 1986). A recoupment, like a setoff, is not included within the meaning of transfer. *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993) ("It is well settled, moreover, that a bankruptcy defendant can meet a plaintiff-debtor's claim with a counterclaim arising out of the same transaction, at least to the extent that the defendant merely seeks recoupment. . . . Recoupment permits a determination of the 'just and proper liability on the main issue,' and involves 'no element of preference.'").

Petitioners challenge only the holding that if their claims arise under section 547(b) of the Bankruptcy Code they are defeated by Respondent's ordinary course defense under section 547(c)(2). They do not challenge either of the Seventh Circuit's alternative holdings regarding recoupment and assignment.[2]

Each individual RAL transaction may vary slightly. Respondent and Petitioners agreed to submit the present issues to the bankruptcy court on the basis of a stipulation that reflects the variations in each RAL transaction. *See* Pet. App. E.

As the first step in a Household RAL transaction, the Debtor applies for a RAL from Respondent. *Id.* ¶3(a). The RAL application (the "Application"), signed by the Debtor prior to obtaining the RAL proceeds, provides:

> I acknowledge, understand and agree that . . . my signing of this Application and the IRS Transmittal Form 8453 or Authorization constitutes an irrevocable transfer to [Respondent] of all my rights, title, and interest in the proceeds of my tax refund upon my receipt of, and to the extent of, my RAL obtained this year, and to the extent of any delinquent RALs I received in previous years from [Respondent].

Id. exh. A ¶10F & exh. B ¶9F. Respondent creates an account (the "Account") for the sole purpose of receiving the proceeds of the tax refund. *Id.* ¶3(b) & exh. C. The Debtor

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[2] Petitioners suggest but do not argue that the petition should be granted based on a contention that was not raised in the bankruptcy court: RALs are improvident. Pet. at 5. Petitioners do not contend here, and did not argue below, that the RALs at issue are unlawful or otherwise voidable under any of the applicable federal statutes regulating consumer finance. Despite extended *dicta*, the court of appeals recognized that considerations about customers' wisdom in obtaining RALs or the efficacy of the RAL in general are no part of this case. *Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 640 (7th Cir. 2003).

never has access to, or control over, the Account. *Id.* ¶3(h). Respondent retains exclusive possession and control over the Account at all times. *Id.* As part of the application process, the Debtor also completes Form 8453, which irrevocably grants consent to the tax refund being directly deposited into the Account. *Id.* ¶3(c) & exh. D. The Debtor also irrevocably designates the Account for deposit of the tax refund by putting the routing and Account numbers on lines 66(b) and 66(d) of Form 1040. *Id.* exh. C.

Respondent issues the Debtor a check in the amount of her tax refund, less fees, within a few days after receiving the signed Application. *Id.* ¶3(e). Subsequently,[3] the IRS sends Respondent an electronic funds transfer ("EFT") in the amount of the tax refund. *Id.* ¶3(f). Immediately thereafter, Respondent transfers the funds from the Account to an account in its own name. *Id.* ¶3(g). Respondent issues a new check to the Debtor if the tax refund exceeds the Debtor's RAL plus fees.[4]

In all of the cases in this consolidation, the RAL transaction followed the loan documents: after Respondent issued the RAL, it received an EFT from the IRS that covered the RAL amount. Subsequent to and within ninety days of completing the RAL process, the Debtors each filed a Chapter 7 bankruptcy petition. In most cases, Respondent received the EFT from the IRS before the bankruptcy filing; in a few

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[3] The amount of time between the issuance of the RAL and the IRS payment varies depending on when the Debtor picks up her check—the electronic funds transfer from the IRS always comes on the same day of the week. Times varied from four to sixteen days. Pet. App. E exhs. G-K.

[4] Although not common, this occurs when Respondent issues a split RAL—loaning only a portion of the anticipated tax refund. Fewer than ten of the RALs at issue in these cases were split. Where the RAL was split, Petitioners only are seeking to avoid Respondent's retention of funds in the Account equal to the RAL amount, and not the transfer of the excess to the Debtor.

cases, however, Respondent received the EFT from the IRS after the Debtor filed the bankruptcy petition. *Id.* exhs. G-K. At all times relevant hereto, Respondent undertook all activities with respect to the RAL transactions, such as those at issue in this instance, in the ordinary course of Respondent's business or financial affairs and in accordance with the ordinary business terms of the Tax Refund Loan industry. *Id.* ¶8. An overwhelming majority of the Debtors are repeat RAL customers: eighty received RALs from Respondent during at least one previous year and thirty-eight of the eighty received RALs from Respondent for at least three prior tax years.[5] *Id.* exhs. G-K.

REASONS FOR DENYING THE PETITION

Petitioners' request for a writ of certiorari addresses only one of the court of appeals' three alternative holdings. This is a fatal flaw: either of the two unchallenged alternative holdings adopted by the court below completely disposes of Petitioners' claims, and a reversal of the Seventh Circuit's holding on the sole issue raised by Petitioners would not result in a reversal of the Seventh Circuit's decision. Accordingly, the petition is a wholly inappropriate vehicle for considering the question presented, assuming the question met other cert-worthy requirements.

In addition, Petitioners' basis for seeking certiorari of the Seventh Circuit's holding is Petitioners' claim that there is a split of authority among the Circuit Courts as to the proper method for applying section 547(c)(2)(B) of the Bankruptcy Code. Petitioners specifically assert that the opinion below conflicts with a recent Eighth Circuit decision. A cursory examination of both opinions reveals, however, that there is no conflict between the Seventh Circuit decision and *In re*

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[5] The Debtors' history, if any, with other RAL providers is not in the record, or known to Respondent.

Armstrong, 291 F.3d 517 (8th Cir. 2002). Indeed, the *Armstrong* opinion did not address section 547(c)(2)(B)—the section of the Bankruptcy Code upon which the petition here solely is based. Finally, the statutory interpretation advanced by Petitioners is neither supported by *Armstrong*, the only case upon which they rely, nor by the policy underlying the particular provision of the Bankruptcy Code.

I. THE ALTERNATIVE HOLDINGS BELOW DISPOSE OF THE CASE WITHOUT RECOURSE TO THE PROPOSED QUESTION PRESENTED

Although mostly concerned with Respondent's ordinary course of business affirmative defense, the Seventh Circuit's decision actually included three alternative holdings in Respondent's favor. Only one of the three—that the transfers sought to be avoided fell within the ordinary course of business exception under section 547(c)(2) of the Bankruptcy Code—is the subject of the petition. The Seventh Circuit, as well as the two lower courts, also held that a RAL repayment is an unavoidable recoupment. *Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 643 (7th Cir. 2003) ("The reality of a RAL process, however, is more accurately viewed as a single integrated transaction."); *In re Warsco*, 272 B.R. 246, 253 (Bankr. N.D. Ind. 2002). This holding, which is not challenged by Petitioners, is wholly dispositive of all cases in this consolidation and therefore is sufficient in itself to mandate affirmance of the Seventh Circuit's opinion.[6] The

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[6] Had Petitioners raised this issue, the decisions below would be affirmed. The parties do not dispute that recoupment is recognized by bankruptcy courts and that if a RAL repayment is a "recoupment" it is unavoidable. The dispute focuses solely on whether the repayment, when it is characterized as a credit transaction, constitutes an avoidable "setoff" or an unavoidable "recoupment." Each of the courts below found that a RAL repayment is an unavoidable recoupment. Applying either of the tests to determine whether the obligations arise from the same

Seventh Circuit also ruled on an issue that was argued but not decided in either the bankruptcy court or the district court; the court of appeals held that each Debtor assigned her tax refund to Respondent prior to receiving a RAL, such that, at the time Respondent received the funds from the IRS, Respondent already held title to the tax refund. *Kleven*, 334 F.3d at 643 (Respondent "held title to the funds when they were received at the bank and then transferred to the bank's own account . . . ."). Thus, repayment of a RAL is not a transfer on account of an antecedent debt, and therefore is not avoidable. 11 U.S.C. § 547(b)(2). This holding, which was not raised in the petition, is also completely dispositive of the controversy.[7]

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transaction—*compare In re TLC Hosps., Inc.*, 224 F.3d 1008, 1012 (9th Cir. 2000) (*citing Moore v. New York Cotton Exch.*, 270 U.S. 593, 610 (1926) and adopting a "logical relationship" test) *with In re Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992) (rejecting logical relationship test and adopting more limited approach)—the courts below found that mutual RAL obligations, if they exist at all, arise from a single integrated transaction. The reasoning is that Respondents extend the RALs, and the Debtors incur the debts, solely in anticipation of repayment by receipt of the tax refunds. The one—granting the loan—is inextricably linked to the other—the debt arising from receipt of the refund into the Account—and both arise from a single contract. *Kleven*, 334 F.3d at 643; *Warsco*, 272 B.R. at 253.

[7] This holding is also correct and thus would not be reversed, even if it fell within the scope of Petitioners' question presented. *See In re Martin*, 167 B.R. 609, 616 (Bankr. D. Or. 1994) (holding transfer unavoidable due to assignment in nearly identical RAL context); *In re Swartz*, 119 B.R. 219 (Bankr. D. Idaho 1990) (same). Delaware law, the law applicable to the RAL documents, provides that an assignment is effective when it manifests the assignor's intent to make a present transfer of the right without further action. *Coca-Cola Bottling Co. of Elizabethtown, Inc. v. Coca-Cola Co.*, 654 F. Supp. 1419, 1440-41 (D. Del. 1987). Every aspect of the RAL transaction manifests an intentional and effective assignment to Respondent of Debtor's beneficial interest in the tax refund; each Debtor took all steps necessary to unconditionally grant possession of

The significance of the alternative holdings in the courts below cannot be overstated. Unlike the holding that the ordinary course of business defense precludes recovery under Petitioners' preferential transfer claims—which could not defeat the avoidance of post-petition transfers—the recoupment and assignment holdings apply to each and every one of the cases in the consolidation. Petitioners take no exception from either holding. Thus, even if this Court were to agree that the courts below erred in their application of the ordinary course of business defense to the facts of these cases, the Court would nevertheless affirm the judgments below based on the two alternative holdings. Therefore, the Petition for Writ of Certiorari should be denied.

II. THERE IS NO CIRCUIT SPLIT—THE RULING BELOW DOES NOT CONFLICT WITH *IN RE ARMSTRONG*

Even if the Court concludes that the issue presented by Petitioners is relevant and potentially case-dispositive, it should nonetheless deny the petition. The only basis raised by Petitioners for review of the opinion below is that there is an alleged split of authority between the Circuit Courts regarding application of the ordinary course of business defense set forth in section 547(c)(2). There is no such split.

Petitioners assert that the Seventh Circuit based its opinion on an "assum[ption] that the transaction is 'ordinary' for each of the individual Debtors, even without the benefit of facts relating to the treatment the Debtors afford their other creditors." Pet. at 7. Petitioners then claim that the Eighth Circuit, in *In re Armstrong*, "held that the 'ordinary course of business' defense in a consumer transaction requires evidence that the transaction is 'within the ordinary course of the

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their income tax refund proceeds to Respondent at the time of the RAL application.

debtor's financial affairs.'" *Id.* The "split," therefore, is the alleged failure of the Seventh Circuit to require a factual finding of "ordinary" on the part of the Debtors in the present case, a finding that the Eighth Circuit required. Petitioners misread the opinion below. The Seventh Circuit did make a factual finding that the transactions were ordinary as to the Debtors, in accordance with well-established tests of "ordinary."[8] *Kleven*, 334 F.3d at 642.

There are three separate prongs to the ordinary course of business defense. Section 547(c)(2) of the Bankruptcy Code shields a transfer from avoidance if the following three elements are met: the transfer (A) was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) was made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) was made according to ordinary business terms. 11 U.S.C. § 547(c)(2)(A)-(C). Only paragraph (B) is at issue in the petition. Pet. at 3, 5.

The *Armstrong* court applied only paragraph (A), finding that because the requirements of that paragraph were not met, the court did not have to reach paragraphs (B) or (C). *In re Armstrong*, 291 F.3d at 527-28. *Armstrong* therefore is not relevant to the question presented in this case. Further, nothing about the *Armstrong* opinion conflicts with the decisions below. In applying Section 547(c)(2)(A), the *Armstrong* court first discussed the "policy background framing the ordinary business exception," namely "(1) to encourage creditors to continue dealing with troubled debtors, and (2) to promote equality of distribution." *Id.* (citing *Union Bank v. Wolas (In re ZZZZ Best Co.)*, 502 U.S. 151, 161 (1991)). Here, the Seventh Circuit likewise recognized the

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[8] Petitioners disagree with the Seventh Circuit's application of the tests for "ordinary" to the facts present, but this is insufficient basis for this Court to accept review. SUP. CT. R. 10.

two purposes for the exception to the Trustees' avoidance power. *Kleven*, 334 F.3d at 641 ("The purpose of this section is two-fold. It is designed to promote equality of distribution among all creditors while simultaneously it deters creditors from 'racing to the courthouse to dismember the debtor during [his] slide into bankruptcy.'") (quoting *Wolas*, 502 U.S. at 161). The Eighth Circuit then reviewed the facts of the case, in light of the purposes of the exception. The *Armstrong* case involved the incurrence of gambling debt by a man who was gambling in a desperate attempt to hide substantial losses caused by his illegal activity. The court easily concluded that the gambling debt was not incurred in the debtor's ordinary course of business:

> That Armstrong was not a professional gambler is certainly a probative fact to take into account in assessing whether or not the transaction was within his ordinary business affairs, but it is not dispositive. More important here is that Armstrong's purpose for gambling, other than entertainment, was to cover huge losses arising from Armstrong's fraud, embezzlement, and Ponzi schemes. . . . We decline to hold that a desperate debtor's irresponsible accumulation of gambling debts in an ill-fated attempt to cover fraud and embezzlement losses qualifies as the ordinary course of his business or financial affairs.

In re Armstrong, 291 F.3d at 527.

The Seventh Circuit likewise made a factual inquiry, and concluded that the Debtors incurred the debts in the ordinary course of business. *Kleven*, 334 F.3d at 642-43. Unlike significant gambling debt incurred by someone, who is not a professional gambler, in a last-ditch effort to avoid discovery of an illegal Ponzi scheme, the Debtors in the present cases took out refund anticipation loans that are taken out by "millions of people." *Id.* at 639.

There is simply no split in authority: the Seventh and Eighth Circuits both require a factual showing that the debtor incurred the debt in the ordinary course of the debtor's business. Both circuits reviewed the record in light of the purposes of the preference statute, determining whether the payments were "ordinary" or whether there was undue pressure or other unusual circumstances. The Seventh Circuit did not apply a novel or unusual legal standard, but rather examined the facts of this case in light of established jurisprudence applying the preference statute. As there is no split between the Circuit Courts regarding application of the ordinary course of business defense, Petitioners fail to demonstrate a need for review by this Court.

III. PETITIONERS' PROPOSED METHOD FOR APPLYING SECTION 547(C)(2) IS INCONSISTENT WITH CASE LAW AND THE STATUTE

This Court should also deny review of the Seventh Circuit's opinion because Petitioners' proposed method for applying section 547(c)(2)(B) is inappropriate. The determination of "ordinariness" under section 547(c)(2)(B) is fact specific. If there is a prior relationship between debtor and creditor, the court examines that relationship to judge what is ordinary. *See In re Gulf City Seafoods, Inc.*, 296 F.3d 363, 368 n.4 (5th Cir. 2002); *In re Midway Airlines, Inc.*, 69 F.3d 792, 797-98 (7th Cir. 1995); *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497 (8th Cir. 1991). When there is no prior relationship between the parties, the court examines whether the "transaction would not be out of the ordinary for a person in the borrower's position." *In re Finn*, 909 F.2d 903, 908 (6th Cir. 1990). All three courts below applied these well established tests. Instead of those standards, Petitioners assert, without citing any direct authority,[9] that a court, when

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[9] Petitioners cite only *Armstrong*, but it provides no support for their position.

determining what constitutes "ordinary course," should compare the types of debt and methods of payment a debtor engaged in with other creditors. Pet. at 7.

Further, Petitioners' proposed test not only is unsupported, but is inconsistent with the statutory scheme. First, the language of the statute does not support Petitioners' argument. Section 547(c)(2)(A), provides that the transfer must be "incurred by the debtor in the ordinary course of business or financial affairs of the debtor *and* the transferee." 11 U.S.C. § 547(c)(2)(A) (emphasis added). Section 547(c)(2)(B) provides that the transfer must be "made in the ordinary course of business or financial affairs of the debtor *and* the transferee." 11 U.S.C. § 547(c)(2)(B) (emphasis added). Thus, section 547(c)(2)(A) and (B) focuses on the relationship between the *debtor and the transferee* and not on the debtor's relationship with third parties.

In addition to being inconsistent with the statute and the case law, the rigid test proposed by Petitioners, particularly in the context of a first-time RAL transaction, is contrary to sound bankruptcy policy. The goal of the ordinary course of business defense is to leave undisturbed normal commercial and financial relationships and protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of both the debtor and the debtor's transferee. *In re Midway Airlines*, 69 F.3d at 797; *In re Classic Drywall, Inc.*, 121 B.R. 69, 75 (D. Kan. 1990); H.R. Rep. No. 95-595, at 177-78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138; S. Rep. No. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874. As noted in the courts below, the rationale of this policy is, among other things, to encourage creditors to continue to do business with potential debtors and to discourage creditors from racing to the courthouse to dismember the debtor during her slide into bankruptcy. *See Union Bank v. Wolas, (In re ZZZZ Best Co.)*, 502 U.S. 151, 161 (1991); *Advo-System, Inc. v. Maxway*

Corp., 37 F.3d 1044, 1047 (4th Cir. 1994); *In re Air South Airlines*, 247 B.R. 165, 170 (Bankr. D.S.C. 2000).

These policy goals would be ill served by adopting the test proposed by Petitioners. To begin, it is unthinkable that a creditor who contracts with a consumer debtor and gets paid in accordance with both the contract and industry terms should *ever* have a problem establishing the ordinary course of business defense and, in such cases, the law should be construed so as to discourage such suits. Second, it would be very difficult and costly for creditors to apply and prove the test, as it would require extensive analysis of a debtor's dealings with third parties. Third, it would impose a *per se* rule completely preventing creditors from establishing the defense against a claim that would be typical for numerous consumers but is asserted by an individual consumer who enters into that type of debt infrequently. For example, under Petitioners' test, a phone company would be precluded from establishing the ordinary course of business defense against any debtor who sets up an automatic deduction for payment of her phone bill but pays all other bills by check. Fourth, even if the debtor transacted business with other similarly situated creditors, there is no valid reason why *those* relationships must determine whether a transaction *between the debtor and the creditor* was ordinary. In sum, adoption of Petitioners' test would eviscerate the ordinary course of business defense and, in so doing, discourage creditors from extending credit to parties on the verge of bankruptcy.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

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